CAUSE NO. D-1-GN-21-006290

RYAN, LLC,	§	IN THE DISTRICT COURT
	§	
Plaintiff,	§	
	§	
v.	§	
	§	
GLENN HEGAR, IN HIS OFFICIAL CAPACITY AS COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS AND THE OFFICE OF THE COMPTROLLER OF PUBLIC ACCOUNTS FOR THE STATE OF TEXAS,	§	353rd JUDICIAL DISTRICT
	§	
Defendants.	§	TRAVIS COUNTY, TEXAS

PLAINTIFF'S RESPONSE TO DEFENDANTS' MOTION FOR SUMMARY JUDGMENT

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ARGUMENT

I. The Amended Rules make Texas less, not more, economically competitive in research and development.

Texas adopted the research and development tax incentives at issue to make Texas economically competitive in attracting research and development investment and activities. Supporters of that legislation specifically identified two states with which the intent was to make Texas more competitive: Massachusetts and California.[1] With regard to Massachusetts, the supporters stated that "Massachusetts offers a 10 percent credit for qualified research expenses, as well as a sales tax exemption. Even though Texas is three times the size of Massachusetts, the research and development is the same size as that of Texas."[2] As for California, supporters stated that "California offers a research and development credit of upwards of 24 percent for entities contracting with higher education institutions. Incentives like this work, as California has 23 percent of the nation's research and development, whereas Texas has about 5 percent."[3]

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[1] House Research Org., Bill Digest, Tex. HB 800, 83rd Leg., R.S. (2013).
[2] *Id.*
[3] *Id.*

Neither California nor Massachusetts has requirements that are comparable to those in the Amended Rules that are the subject of this suit. Both California and Massachusetts provide that the amount of the credit is determined in accordance with I.R.C. § 41.[4] Further, neither state imposes the recordkeeping requirement or heightened burden of proof in the Amended Rules.[5]

The Comptroller asserts that he adopted the Amended Rules "after an extensive and thorough process of notice and comment governed by the Texas Administrative Procedure Act."[6] According to the Comptroller, he "reviewed and considered each comment and responded to the comments in the publication of the final versions of the rules."[7]

If those statements are true, then the Comptroller disregarded serious concerns that commentors raised that the rule amendments will impede the goal of increasing research and development. In a joint

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[4] CAL. REV. & TAX CODE §§ 17052-12 & 23609 (West 2022); MASS. GEN. LAWS ch. 63, § 38M (West 2022); MASS. GEN. LAWS ch. 64H, § 6(r) & (s) (West 2022).

[5] *See In re Charles Walden & Deborah Anderson, Charles Walden, & Walden Structures, Inc.*, Case Nos. 18010221, 18010222, 18010223, 2018 WL 10151186, at *16-18 (Office of Tax Appeals, State of California, November 28, 2018); 830 Mass. Code Reg. § 63.38M.1(14) (2022).

[6] Defendants' Motion for Summary Judgment, p. 6.

[7] *Id.*

comment, the Texas Taxpayers Research Association and the Council on State Taxation stated as follows:

> We have concerns that the agency's proposed rules will make Texas' incentive narrower and more restrictive than the legislature intended. ***Texas' R&D provisions will be less attractive than that available in 34 other states.*** That will harm Texas' ability compete with other states for R&D investment and hamper the ability of the state to achieve the purposes of the original Act. We believe the state should do nothing to blunt this development, and are concerned that the rules as proposed would severely constrain what the Texas Legislature intended as a generous invitation to businesses to invest in R&D activities in the state.[8]

Tax professionals have likewise commented that the Amended Rules frustrate the Legislative goals of the research and development franchise tax credit and sales tax exemption. An article that was recently published in Tax Notes State provides that "'Business-friendly' Texas has been the leading poacher of California-based companies for over a decade, with relocations form tech-dominated California only accelerating during the pandemic. Oddly enough, at a time when Texas's highest-profile new neighbors are known for cutting-edge research, the state seeks to narrow

[8] Appendix 20, pp. CPA002080-CPA002081 (emphasis added).

the scope of its research and development credit applicable to some internal-use software."[9]

The Amended Rules impose qualification and procedural requirements that are greater than what other states impose for their research and development tax incentives. As a result, the rule amendments frustrate the Legislative objectives of the Texas research and development tax incentives.

II. Research does not need to be "innovative" or "cutting-edge" to be "qualified research."[10]

In 2013, Texas enacted HB 800 into law.[11] HB 800 modified the Tax Code to allow a taxpayer to take: (i) a sales tax exemption for "tangible personal property directly used in qualified research"; or (ii) a credit against the franchise tax that is calculated by reference to "the qualified

[9] Jeffrey A. Friedman et al., The Texas R&D Credit: Comptroller's Regs Could Hogtie Taxpayers, Tax Notes State, Volume 103 (March 21, 2022) (Appendix 18).
[10] Responding to Section I.
[11] Act of June 14, 2013, 83d Leg., R.S., ch. 1266, § 1, 2013 Tex. Gen. Laws 3206, 3206 (codified at Subtitle F, Chapter 171, Subchapter M, of the Texas Tax Code and Tex. Tax Code § 151.3182).

research expenses incurred."[12] The stated Legislative purposes of HB 800 are as follows:

a. Make Texas economically competitive in the field of research and development;

b. Reduce the tax burden on research and development activities in Texas and encourage new investments in this state;

c. Promote the creation of new, highly skilled, high-paying jobs in Texas; and

d. Complement this state's manufacturing industries by encouraging innovation and efficiency in applying new technologies and producing new products.[13]

In his Motion for Summary Judgment, the Comptroller asserted that the Amended Rules further those purposes by ensuring that the franchise tax credit and sales tax exemption are only available to those taxpayers who are engaged in "cutting-edge" or "innovative" research and development.[14] The Comptroller further explained that assertion by providing two examples:

- "If, for example, the R&D tax breaks applied to run-of-the mill software programming—such as building websites and cell-phone

[12] *Id.*
[13] *Id.*
[14] Defendants' Motion for Summary Judgment, p. 9.

apps—companies would have no tax incentive to hire highly skilled workers who could ***expand the horizons of computer science***."[15]

- "In the same vein, if an oil-and-gas company could get an R&D tax break for ordinary drilling activities, the company would have no tax incentive to invest in ***exploring the frontiers of geoscience***."[16]

The Comptroller's assertion that research must be "cutting-edge" or "innovative" to qualify should be rejected because (1) the relevant legal authorities do not contain such a requirement; (2) the Treasury Department rejected that standard over twenty years ago; and (3) a requirement that research be "cutting-edge" or "innovative" is unworkable.

A. The relevant legal authorities do not require research to be "cutting-edge" or "innovative" for it to be "qualified research."

A taxable entity may claim a credit against its Texas franchise tax liability for certain research and development activities. The amount of the credit is based upon the amount of "qualified research expenses" the

[15] *Id.* (emphasis added).
[16] *Id.* (emphasis added).

taxable entity pays or incurs.[17] Likewise, depreciable tangible personal property that is directly used in "qualified research" is exempt from the Texas sales tax.[18] The Tax Code provides that the terms "qualified research" and "qualified research expenses" have the meaning assigned by I.R.C. § 41 and the applicable Treasury Regulations, except that the research must be conducted in Texas.[19]

The reference to I.R.C. § 41 in the Texas statutes shows that the research and development activities the Legislature wanted to encourage are those that qualify for the federal tax incentive. In other words, all activities that constitute "qualified research" under federal law qualify for the Texas tax incentives so long as the activities are conducted in Texas.

Under federal law, research and development does not need to be "innovative" or "cutting-edge" to qualify. Instead, research qualifies "if it is intended to eliminate uncertainty concerning the development or improvement of a business component."[20] "Uncertainty exists ***if the***

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[17] TEX. TAX CODE § 171.654(a).
[18] *Id.* § 151.3182(b).
[19] *Id.* § 171.651(1), (3), & (4).
[20] Treas. Reg. § 1.41-4(a)(3)(i).

information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component."[21] "A determination that research is undertaken for the purpose of discovering information that is technological in nature ***does not require*** the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research."[22]

Further, "[a] taxpayer may undertake a process of experimentation ***if there is no uncertainty*** concerning the taxpayer's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxpayer's research activities."[23]

The applicable Treasury Regulations provide several examples of these concepts, one of which is particularly informative:

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[21] *Id.* (emphasis added).
[22] *Id.* § 1.41-4(a)(3)(ii) (emphasis added).
[23] *Id.* § 1.41-4(a)(5)(i) (emphasis added).

Example 3. (i) Facts. X is engaged in the business of manufacturing food products and currently manufactures a large-shred version of a product. ***X seeks to modify its current production line to permit it to manufacture both a large-shred version and a fine-shred version of one of its food products.*** A smaller, thinner shredding blade is capable of producing a fine-shred version of the food product, however, is not commercially available. Thus, X must develop a new shredding blade that can be fitted onto its current production line. X is uncertain concerning the design of the new shredding blade, because the material used in its existing blade breaks when machined into smaller, thinner blades. X engages in a systematic trial and error process of analyzing various blade designs and materials to determine whether the new shredding blade must be constructed of a different material from that of its existing shredding blade and, if so, what material will best meet X's functional requirements.

(ii) Conclusion. ***X's activities*** to modify its current production line by developing the new shredding blade ***meet the requirements of qualified research*** as set forth in paragraph (a)(2) of this section. Substantially all of X's activities constitute elements of a process of experimentation because X evaluated alternatives to achieve a result where the method of achieving that result, and the appropriate design of that result, were uncertain as of the beginning of the taxpayer's research activities. X identified uncertainties related to the development of a business component, and identified alternatives intended to eliminate these uncertainties. Furthermore, X's process of evaluating identified alternatives was technological in nature, and was undertaken to eliminate the uncertainties.[24]

[24] Treas. Reg. § 1.41-4(a)(8) (Example 3).

Developing a thinner shredding blade can hardly be described as "cutting-edge" or "innovative." Likewise, no one would describe that process as "expanding the horizons" or "exploring the frontiers" of science. As the example explains, however, those activities undoubtedly qualify for the federal research and development credit. If those activities are conducted in Texas, then they also qualify for the Texas research and development tax incentives. Accordingly, research that is not "innovative" or "cutting-edge" can constitute "qualified research."

The Texas Supreme Court has rejected similar attempts by the Comptroller to insert additional requirements into statutory provisions. In *Sirius XM*, the Comptroller argued that where services are performed should be determined based upon a "receipt-producing, end-product act" test.[25] The Texas Supreme Court rejected that assertion and explained:

> ***The focus should be on the statutory words themselves, not on extraneous concepts*** like "receipt-producing" or "end-product act," which do not appear in the statute and, when applied, may or may not yield the same result as a straightforward application of the words chosen by the Legislature. That is not to say the statutory text is always easy to apply. It is not. But it should not be replaced by words of limitation or expansion not chosen by the Legislature. Setting aside the atextual and unhelpful "receipt-producing,

[25] *Sirius XM Radio, Inc. v. Hegar*, 643 S.W.3d 402, 407 (Tex. 2022) (emphasis added).

> end-product act" test, the most natural reading of "service performed in this state" supports locating the performance of the service at the place where the taxpayer's personnel or equipment is physically doing useful work for the customer.[26]

B. The Treasury Department rejected the standard advocated by the Comptroller twenty years ago.

The Internal Revenue Code defines "qualified research" as research that, among other things, is undertaken for the purpose of discovering information which is technological in nature.[27] In the 2001 Final Regulations, which were adopted on January 3, 2001, the Treasury Department defined the phrase "for the purpose of discovering information" as "undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."[28]

The IRS issued Notice 2001-19 a month after the adoption of the 2001 Final Regulations.[29] In that notice, the IRS stated that "the Treasury Department and the IRS will review the research credit final regulations in T.D. 8930 (2001-5 I.R.B. 433), and that comments are

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[26] *Id.* at 408.
[27] I.R.C. § 41(d)(1)(B)(i).
[28] T.D. 8930, § 1.41-4(a)(3)(i) (Appendix 9).
[29] I.R.S. Notice 2001-19, 2001-1 C.B. 784 (Feb. 1, 2001) (Appendix 21).

requested on the final regulations. Upon completion of this review, Treasury and the IRS will announce changes to the regulations, if any, in the form of proposed regulations."[30]

The IRS published the Proposed Regulations on December 26, 2001.[31] The Proposed Regulations did not contain the requirement in the 2001 Final Regulations that research must be "undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."[32] The Treasury Department provided the following explanation regarding why it removed this requirement:

> Based upon their review of these comments, the statute and legislative history, Treasury and the IRS have determined that the definition of qualified research set out in TD 8930 ***does not fully address Congress' concerns regarding the importance of research activities to the U.S. economy***. Accordingly, Treasury and the IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.[33]

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[30] *Id.*
[31] 2002-1 C.B. 404 (Dec. 26, 2001) (Appendix 10).
[32] T.D. 8930, § 1.41-4(a)(3)(i); 2001-C.B. 4040 (Appendix 9).
[33] *Id.*

The Comptroller advocates for a standard that requires research to be "cutting-edge" or "innovative" to qualify for the Texas tax incentives. That position was specifically rejected by the Treasury Department twenty years ago when it removed the requirement that "research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."

C. The standard the Comptroller advocates is unworkable.

The Comptroller's position that research is not "qualified research" unless it is "cutting-edge" or "innovative" should be rejected for another reason: It is an unworkable standard.

Courts have attempted to resolve disputes regarding what it means for a product to be "innovative" or "cutting-edge" in the context of securities and consumer fraud claims. In each of those cases, however, the court has found those words to not be actionable because they are too vague.

In *In re Pivotal Securities Litigation*, the court found that the defendants' statements that the company provided a "cutting-edge," "leading," and "turnkey cloud-native platform" not actionable because

these statements were "vague assessments that represent the feel good speak that characterizes non-actionable puffing."[34]

Likewise, the U.S. District Court for the District of New Jersey held that claims that products are "top-quality," "innovative," and "dependable" with "great warranties" and "excellent customer service" were neither measurable nor concrete, and simply too imprecise to be considered material.[35]

Finally, the U.S. District Court for the District of Arizona noted that courts have found that the word "innovative" is "not specific, not concrete, not measurable, and therefore puffery" and "the generalized and vague statements of product superiority such as . . . 'more innovative than competing machines' are non-actionable puffery."[36]

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[34] *In re Pivotal Securities Litigation*, No. 3:19-cv-03589-CRB, 2020 WL 4193384, at *7 (N.D. Cal. July 21, 2020).
[35] *Argabright v. Rheem Mfg. Co.*, 201 F.Supp.3d 578, 608 (D. New Jersey 2016).
[36] *Soilworks, LLC v. Midwest Indus. Supply, Inc.*, 575 F.Supp.2d 1118, 1133 (D. Ariz. 2008) (quoting *Rosenthal Collins Group, LLC v. Trading Techs. Int'l, Inc.*, No. 05-C-4088, 2005 WL 3557947, at *10 (N.D. Ill. Dec. 26, 2005); *Oestreicher v. Alienware Corp.*, 544 F.Supp.2d 964, 973 (N.D. Cal. 2008)).

III. Rules that set "bright lines" are invalid if they contravene specific statutory language, run counter to the statute's general objectives, or impose burdens, conditions, or restrictions in excess of the relevant statutory provisions.

In his Motion for Summary Judgment, the Comptroller repeatedly justifies the Amended Rules by asserting that those rules provide "bright-line" tests.[37]

All rules, whether they set bright lines or not, are invalid if they are "contrary to the relevant statute."[38] A rule is contrary to the relevant statute if it "(1) contravenes specific statutory language; (2) runs counter to the general objectives of the statute; or (3) imposes additional burdens, conditions, or restrictions in excess of or inconsistent with the relevant statutory provisions."[39] Administrative convenience cannot save a rule that fails one of those three requirements.

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[37] Defendants' Motion for Summary Judgment, pp. 22-25

[38] *Hegar v. Ryan, LLC*, No. 03-13-00400-CV, 2015 WL 3393917, at *7 (Tex. App.—Austin May 20, 2015, no pet.) (mem. op.) (quoting *DuPont Photomasks, Inc. v. Strayhorn*, 219 S.W.3d 414, 420 (Tex. App.—Austin 2006, pet. denied)).

[39] *Id.* (quoting *Office of Pub. Util. Counsel v. Pub. Util. Comm'n*, 131 S.W.3d 314, 321 (Tex. App.—Austin 2004, pet. denied)).

IV. The Comptroller's proposed amendments to Amended Rules 3.340(a)(6), 3.599(b)(5), and 3.599(d)(5) do not cause Ryan's challenges to those sections to become moot.

In his Motion for Summary Judgment, the Comptroller stated that "[h]aving filed proposed amendments to 34 Tex. Admin. Code sections 3.340(a)(6), 3.599(b)(5), and 3.599(d)(5) with the Secretary of State, the Comptroller will not defend Ryan, LLC's challenges to those portions of the rules."[40] The Comptroller attached those proposed amendments as exhibits to his Motion for Summary Judgment.[41]

Rules 3.340(a)(6) and 3.599(b)(5) concern the definition of "Internal Revenue Code." The proposed amendments would change that definition as follows (additions are underlined and deletions are in brackets):

> (6) Internal Revenue Code (IRC)--The Internal Revenue code of 1986 in effect on December 31, 2011, excluding any changes made by federal law after that date, but including any regulations adopted under the code applicable to the tax year to which the provisions of the code in effect on that date applied. A regulation adopted after December 31, 2011 is only included in this term to the extent that [the regulation requires] a taxpayer could have applied [to apply] the regulation to the 2011 federal income tax year. Examples of treasury regulations included in this definition are:

[40] Defendants' Motion for Summary Judgment, p. 7 fn. 1.
[41] *Id.*, Exhibits 1 & 3.

(A) Treasury Regulation, 1.174-2 (Definition of research and experimental expenditures) as contained in 26 CFR part 1 (revised as of July 21, 2014);

(B) Treasury Regulation, §1.41-4 (Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003) as contained in 26 CFR part 1 (revised as of November 3, 2016), except for paragraph (c)(6) (Internal use software). For paragraph (c)(6), as provided in the last sentence of Treasury Regulation, § 1.41-4(e) (Effective/applicability dates), taxpayers may elect to follow either of the following versions of paragraph (c)(6):

(i) Treasury Regulation, §1.41-4(c)(6) (Internal-use computer software) as contained in 26 CFR part 1 (revised as of April 1, 2003) and IRB 2001-5; or

(ii) Proposed Treasury Regulation, §1.41-4(c)(6) (Internal use software for taxable years beginning on or after December 31, 1985) as contained in IRB 2002-4.

"The mootness doctrine dictates that courts avoid rendering advisory opinions by only deciding cases that present a 'live' controversy at the time of the decision."[42] "A case becomes moot when: (1) it appears

[42] *Hegar v. Ryan, LLC*, 2015 WL 3393917, at *6 (quoting *Texas Health Care Info. Council v. Seton Health Plan, Inc.*, 94 S.W.3d 841, 846 (Tex. App.—Austin 2002, pet. denied).

that one seeks to obtain a judgment on some controversy, when in reality none exists; or (2) when one seeks a judgment on some matter which, when rendered for any reason, cannot have any practical legal effect on a then-existing controversy."[43]

The proposed amendments to Amended Rules 3.340(a)(6) and 3.599(b)(5) set forth the definition of "Internal Revenue Code" that Ryan contends is the appropriate one. The proposed amendments also identify the Treasury Regulations Ryan asserts are included in that definition.

The proposed amendments, however, are just that: Proposed. The Comptroller could decide to ultimately not adopt those proposed amendments. Until the Comptroller adopts the proposed amendments, there is a live controversy upon which a judgment can have a practical legal effect. Further, Ryan notes that it took the Comptroller eight months to adopt the amendments to Rules 3.340 and 3.599 that are at issue in this case. The Comptroller's proposed amendments to Amended Rules 3.340(a)(6) and 3.599(b)(5), therefore, do not cause Ryan's challenge to those sections to become moot.

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[43] *Id.*

The proposed amendments to Amended Rule 3.599(d)(5), even if adopted, will not cause all of Ryan's challenges to that section to be moot. Amended Rule 3.599(d)(5) deals with the requirements for activities to develop "internal use software" to qualify for the research and development tax incentives. Ryan's challenge to that section was two-fold. First, the definition of "internal use software" is broader than the definition in the relevant Treasury Regulation.[44] Second, the standard to determine whether activities to develop internal use software constitute qualified research in Amended Rule 3.599(d)(5) conflicts with the standard in the relevant Treasury Regulation.[45]

The proposed amendments set forth a definition of "internal use software" that is consistent with the definition set forth in the relevant Treasury Regulation. The Comptroller, however, did not propose any amendments to the standard to determine whether activities to develop internal use software constitute qualified research. Accordingly, the proposed amendments will not cause Ryan's challenge to the definition of "internal use software" to become moot until those proposed

[44] Plaintiff's Motion for Summary Judgment, Argument Section III.D.
[45] *Id.*, Argument Section III.E.

amendments are adopted. Further, the proposed amendments do not include any changes to the standards for internal use software to constitute qualified research. As a result, even the adoption of the proposed amendments will not moot Ryan's challenge to that section.

V. The Comptroller's concession that Amended Rules 3.340(a)(6) and 3.599(b)(5) are invalid is a concession that Amended Rules 3.340(d)(1)(B)(vii), 3.599(d)(1)(B)(vii), and 3.599(b)(8)(A)(iii) are also invalid.[46]

Ryan explained in its Motion for Summary Judgment that a determination that the definition of "Internal Revenue Code" in Amended Rules 3.340(a)(6) and 3.599(b)(5) is invalid causes sections 3.340(d)(1)(B)(vii), 3.599(d)(1)(B)(vii), and 3.599(b)(8)(A)(iii) to likewise be invalid.[47] That determination causes those sections to be invalid because they conflict with portions of Treasury Regulation 1.174-2 (July 21, 2014) that the Comptroller unlawfully excluded from the definition of "Internal Revenue Code."

In his Motion for Summary Judgment, the Comptroller asserts that these sections of the Amended Rules are valid because items cannot be

[46] Responding to Sections IV.I. & K.
[47] Plaintiff's Motion for Summary Judgment, Argument II.C.2. & 3.

used for manufacturing and qualified research.[48] The Comptroller further asserted that items cannot be held for resale and used in qualified research.[49]

Treasury Regulation § 1.174-2, however, provides that "[c]osts may be eligible under section 174 if paid or incurred ***after production begins*** but before uncertainty concerning the development or improvement of the product is eliminated."[50] That regulation also provides that "[t]he ultimate success, failure, sale, or use of the product ***is not relevant*** to a determination of eligibility under section 174."[51] Accordingly, an item may be used for manufacturing or ultimately resold and be a qualified research expense.

VI. The recordkeeping requirement in the Amended Rules is broader than the recordkeeping requirement in the Tax Code: Rules 3.340(b)(6) & 3.599(e)(2)(B).[52]

Amended Rule 3.340(b)(6) provides that "[a]ll qualified research activities must be supported by contemporaneous business records." Likewise, Amended Rule 3.599(e)(2)(B) states that "[a]ll qualified

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[48] Defendants' Motion for Summary Judgment, p. 23 & 25.
[49] *Id.*, p 25.
[50] Treas. Reg. § 1.174-2(a)(1) (emphasis added).
[51] *Id.* (emphasis added).
[52] Responding to Section II.

research expenses must be supported by contemporaneous business records."

The Comptroller contends that the recordkeeping requirement in the Amended Rules is a generally applicable principle of tax law.[53] In support, he points to Tax Code § 111.0041(c), which provides that:

> A taxpayer shall produce contemporaneous records and supporting documentation appropriate to the tax or fee for the transactions in question to substantiate and enable verification of the taxpayer's claim related to the amount of tax, penalty, or interest to be assessed, collected, or refunded in an administrative or judicial proceeding.

Tax Code § 111.0041(c) does not require taxpayers to produce contemporaneous business records to establish every element of a sales tax exemption or franchise tax credit. Instead, that section requires taxpayers to produce documentation "related to the amount of tax, penalty, or interest." Accordingly, the recordkeeping requirement in Tax Code § 111.0041(c) only relates to the "amount of tax."

Further, "[t]he plain language of [Tax Code § 111.0041(c)] . . . ***expressly allows flexibility*** as to the appropriate proof to support a

[53] Defendants' Motion for Summary Judgment, p. 10.

given transaction."[54] The Amended Rules, however, provide no flexibility. Instead, they require that a taxpayer produce contemporaneous business records to establish every element of the research and development franchise tax credit or sales tax exemption.

The flexibility afforded by Tax Code § 111.0041(c) is particularly important in the context of the research and development tax incentives. The IRS attempted to impose a similar recordkeeping requirement when it adopted the 2001 Final Regulations.[55] The IRS removed that requirement when it published the Proposed Regulations later that year and explained that it was doing so because "the high degree of variability in the objectives and conduct of research activities in the United States ***compels*** a conclusion that ***taxpayers must be provided reasonable flexibility*** in the manner in which they substantiate their research credits."[56]

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[54] *Hegar v. Ryan, LLC*, 2015 WL 3393917, at *12.
[55] T.D. 8930, 2001-1 C.B. 433 (Appendix 9).
[56] 2002-1 C.B. 404 (emphasis added) (Appendix 10).

VII. A taxpayer's evidentiary burden in a tax protest or refund suit is preponderance of the evidence, not clear and convincing evidence: Rules 3.340(b)(6) & 3.599(e)(2).[57]

Amended Rules 3.340(b)(6) and 3.599(e)(2)(B) provide that a taxpayer "has the burden of establishing its entitlement to" the research and development franchise tax credit or sales tax exemption "by clear and convincing evidence."

The Comptroller claims that there is nothing new in these sections. Rather, "the rules' inclusion of this burden of proof is simply a restatement of a principle of tax law that applies well beyond the R&D tax breaks."[58] That principle, according to the Comptroller, is that taxpayers must prove their entitlement to exemptions and anything that is tantamount to an exemption by clear and convincing evidence.

The Comptroller cited two cases, *Southwest Royalties*[59] and *National Bancshares*,[60] and Comptroller Rule 1.26 in support of that contention. Neither of those opinions nor the Comptroller Rule, however,

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[57] Responding to Section III.
[58] Defendants' Motion for Summary Judgment, p. 12.
[59] *Sw. Royalties, Inc. v. Hegar*, 500 S.W.3d 400, 404 (Tex. 2016).
[60] *Bullock v. Nat'l Bancshares Corp.*, 584 S.W.2d 268, 271-72 (Tex. 1979).

state that, in district court litigation, taxpayers must prove their entitlement to an exemption by clear and convincing evidence.

The portions of *Southwest Royalties* and *National Bancshares* the Comptroller cited concern how courts should construe statutory tax exemptions, not the factual burden a taxpayer must establish. In fact, the portion of the sentence the Comptroller omitted from the quote he included in his Motion for Summary Judgment from *Southwest Royalties* states that "[t]ax exemptions are narrowly construed."[61] The Texas Supreme Court also stated in that opinion that "[a]lthough statutory tax exemptions are narrowly construed, construing them narrowly does not mean disregarding the words used by the Legislature."[62]

Likewise, Comptroller Rule 1.26 does not apply to district court litigation. Instead, that rule applies to "Contested Cases."[63] A contested case is a "proceeding in which the legal rights, duties, or privileges of a party are to be determined by the agency after an opportunity for an adjudicative hearing."[64] District court litigation is not a contested case.

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[61] *Sw. Royalties*, 500 S.W.3d at 404.
[62] *Id.*
[63] 34 TEX. ADMIN. CODE §§ 1.1 & 1.26.
[64] *Id.* § 1.2(8).

The Comptroller did not provide any legal authority to support his claim that taxpayers must prove their entitlement to an exemption or anything tantamount to an exemption by clear and convincing evidence. Amended Rules 3.340(b)(6) and 3.599(e)(2), therefore, are invalid because they impose burdens, conditions, or restrictions that are in excess of or inconsistent with the statutory provisions.

VIII. Services and designs can be business components: Rules 3.340(c)(1)(C)(i)-(ii) & 3.599(c)(1)(C)(i)-(ii).[65]

Research is "qualified" only if, among other things, it is undertaken for the purpose of discovering information "the application of which is intended to be useful in the development of a new or improved business component of the taxpayer."[66] A "business component" is "any product, process, computer software, technique, formula, or invention which is to be (i) held for sale, lease, license, or (ii) used by the taxpayer in a trade or business of the taxpayer."[67]

The Amended Rules provide that services and designs can never be business components. The Comptroller defends these provisions simply

[65] Responding to Sections IV.A. & B.
[66] I.R.C. § 41(d)(1)(B)(ii)(emphasis added).
[67] *Id.* at § 41(d)(2)(B).

by pointing out that the terms "service" and "design" do not appear in the statutory definition of "business component."

These portions of the Amended Rules potentially exclude entire industries from qualifying for the research and development tax incentives based upon semantics. It is unclear how a "design" could not also constitute a "technique," which is defined as "a method of accomplishing a desired aim."[68] Also, how is a "service" different from a "process," which is "a series of actions or operations conducted to an end"?[69]

The impacted businesses are engaged in research and development, but do not produce the ultimate product. In those situations, there is no dispute that research and development has taken place, but neither the taxpayer who undertook the research and development nor the taxpayer that produced the product are eligible for the research and development tax incentives. The taxpayer that conducted the research is not eligible because they merely provided a "service" or "design." The taxpayer that produced the product is not eligible because it is not the one that

[68] *Technique*, Merriam-Webster's Collegiate Dictionary (11th ed. 2012).
[69] *Process*, Merriam-Webster's Collegiate Dictionary (11th ed. 2012).

conducted the research. This interpretation frustrates the Legislative goals of the research and development tax incentives to make Texas more competitive in research and development.

Further, the sentence in the Treasury Regulations the Comptroller referenced does not support his construction of the statutory definition of "business component." That sentence provides that "[u]ncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component."[70] The reference to the "appropriate design of the business component" in that sentence does not mean that a design can never be a business component.

IX. A "Process of Experimentation" can include the use of commercially available or a taxpayer's existing technology: Rules 3.340(c)(1)(D)(vii)(VII)-(VIII) & 3.599(c)(1)(D)(vii)(VII)-(VIII).[71]

In the Amended Rules, the Comptroller added several examples that supposedly illustrate the application of the Process of Experimentation Test. Ryan explained in its Motion for Summary

[70] Treas. Reg. § 1.41-4(a)(3)(i).
[71] Responding to Sections IV.E. & F.

Judgment[72] that two of those examples (Examples 7 and 8) inappropriately concluded that the taxpayer did not engage in a process of experimentation.

In both examples, the taxpayer is an oil and gas operator that recently acquired rights to drill in an area in which it had not previously operated. The taxpayer decided to use horizontal drilling in this area.

In Example 7, the taxpayer had never drilled a horizontal well and was uncertain how to successfully execute the horizontal drilling. In Example 8, the taxpayer had drilled a horizontal well before in a different formation and at different depths, but it had never drilled a horizontal well in this formation or at the required depths. In both cases, the taxpayer "was uncertain how to successfully execute the horizontal drilling."

The taxpayer in Example 7 "selected technology from existing commercially available options to use in its horizontal drilling program." The taxpayer in Example 8 "utilized its existing technology to perform its horizontal drilling operations in this area and the existing technology

[72] Argument, Section X.

was successful." The examples conclude that neither taxpayer engaged in a process of experimentation because "evaluating commercially available options does not constitute a process of experimentation" and "the taxpayer merely used its existing technology and did not perform any experimentation to evaluate alternative any drilling methods."

The Comptroller stated in his Motion for Summary Judgment that the taxpayer's activities in Example 7 do not constitute a process of experimentation because all the taxpayer did was shop for technology. The Comptroller further stated that shopping for technology is not a process of experimentation because it does not (1) involve the development or improvement of a business component, or (2) fundamentally rely on the principles of physical or biological sciences, engineering, or computer science. The taxpayer's activities in Example 8 do not constitute a process of experimentation, according to the Comptroller, because using existing technology does not enhance or add anything to the technology.

The facts stated in Example 7 do not support the Comptroller's assertion that the taxpayer's activities solely consisted of shopping for technology. The example states that the taxpayer "had never drilled a

horizontal well and was uncertain how to successfully execute the horizontal drilling." The example also states that the "taxpayer selected technology from existing commercially available options ***to use*** in its horizontal drilling program."

The example does not state that (1) the commercially available technology or the taxpayer's existing technology resolved all the taxpayer's uncertainty, (2) the only actions the taxpayer undertook to address its uncertainty was to pick the best commercially available option; (3) the taxpayer did not undertake any other actions to address the uncertainty; or (4) the taxpayer did not need to make any modifications to the commercially available technology to resolve the uncertainty. Without those statements, the example creates a rule that if a taxpayer ***uses*** technology that is commercially available, then no matter what else the taxpayer does, it does not engage in a process of experimentation. This rule is not supported by I.R.C. § 41, the applicable regulations, or case law.

Further, the facts stated in Example 8 do not support the Comptroller's assertion that the use of existing technology does not enhance or add anything to the technology. The example states that

"[t]he taxpayer utilized its existing technology to perform its horizontal drilling operations in this area and the existing technology was successful." The example does not state, however, that the taxpayer did not have to make any modifications to its existing technology. If it did, then, at a minimum, it ***improved*** its existing technology.

The Texas Oil and Gas Association (TXOGA) filed a comment with the Comptroller in which it expressed concerns regarding these examples.[73] "TXOGA is a non-profit corporation representing every sector of the oil and natural gas industry in the state of Texas."[74] In the comment, TXOGA stated that "Examples 7 and 8 are incomplete as they do not take into account the complexities of designing a successful drilling operation and further, that technical uncertainties can—and often do—exist, even when certain elements of the system design are known."[75] TXOGA's concerns are illustrated by the fact pattern of a refund claim Ryan has filed, which is described in the Supplemental Affidavit of Michael Thompson attached as Appendix 23.

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[73] Appendix 22.
[74] *Id.*, p. CPA002314.
[75] *Id.*, p. CPA002315.

In *Trinity Industries, Inc. v. United States*, the United States District Court for the Northern District of Texas addressed a similar argument in the context of a custom manufacturer of ships.[76] Trinity built custom ships pursuant to contracts with its purchasers.[77] Trinity's shipbuilding activities followed a standard six-phase development process: conceptual, contract design, functional design, detail design, construction, and testing.[78] When Trinity designed a new vessel, the first ship it produced is essentially a prototype Trinity referred to as "first in class."[79] Trinity hoped that these first in class ships would result in orders for duplicates but was not certain that this will be the case.[80]

The United States argued that "much of the design work at issue involved integrated extant subassemblies into a ship design" and doing so suggests that Trinity's research activities therefore equated to nothing more than "ordering off a menu: pick a hull from column A, a propulsion system from column B, and HVAC from column C, etc."[81]

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[76] 691 F.Supp.2d 688 (N.D. Tex. 2010).
[77] *Id.* at 691.
[78] *Id.* at 690.
[79] *Id.*
[80] *Id.*
[81] *Id.* at 691-92.

The *Trinity* court found this to be a great oversimplification of the process utilized by Trinity to construct its ships.[82] Specifically, Judge Godbey wrote:

> First, many of the systems at issue are not monolithic entities, but rather families of products with considerable flexibility in their configuration. ***Determining which configuration out of the universe available can in particular cases itself involve a significant research effort.***
>
> Second, ***the systems do not exist in a vacuum.*** They interact with each other, sometimes in complex and nonintuitive ways. A change in electronics may require a change in power generation and distribution, which may require a change in the engine plant, any of which may affect the weight distribution and performance of the vessel as a whole.
>
> Thus, the simple fact that a new vessel incorporates existing systems does not resolve the QRE issue against Trinity. Determining the degree of QRE involved ***requires an examination of the overall scope of the effort required to specify the components and integrate them into the overall design of the ship.***[83]

[82] *Id.*

[83] *Id.* at 692 (emphasis added).

X. The terms "simple trial and error," "brainstorming," and "reserve engineering" do not appear in I.R.C. § 41 or any applicable Treasury Regulation: Rules 3.340(c)(1)(D)(v) & 3.599(c)(1)(D)(v).[84]

The Amended Rules modify the Process of Experimentation Test by providing that simple trial and error, brainstorming, and reverse engineering are not considered processes of experimentation. The Comptroller defended this provision by arguing that trial and error and brainstorming are used in just about every kind of work. The Comptroller used the composition of his Motion for Summary Judgment as an example of something that involved trial and error and brainstorming, but was not a process of experimentation.

The reason the Comptroller's composition of his Motion for Summary Judgment does not constitute "qualified research" is not because of the process he used to draft it. Instead, the drafting of the Motion for Summary Judgment does not constitute a process of experimentation because the Comptroller did not "fundamentally rely on the principles of the physical or biological sciences, engineering, or

[84] Responding to Section IV.G.

computer science."[85] As a result, the Amended Rules do not help distinguish between qualifying and non-qualifying activities as the Comptroller contends.

The terms "simple trial and error," "brainstorming," and "reverse engineering" do not appear in I.R.C. § 41 or any applicable Treasury Regulation. The Amended Rules, therefore, require taxpayers to establish items they would not be required to under those authorities.

XI. Modifying a horizontal-drilling program is not an "adaptation of an existing business component": Rules 3.340(d)(2)(F) & 3.599(d)(2)(F).[86]

Research related to adapting an existing business component to a particular customer's requirement or need does not constitute "qualified research."[87] That exclusion "does not apply merely because a business component is intended for a specific customer."[88] As Ryan explained in

[85] Treas. Reg. 1.41-4(a)(5)(i).
[86] Responding to Section IV.H.
[87] I.R.C. § 41(d)(4)(B).
[88] Treas. Reg. § 1.41-4(c)(3).

its Motion for Summary Judgment, the Comptroller added an example to the Amended Rules that incorrectly applies these rules.

The taxpayer's actions in the example do not constitute adapting an existing business component to a particular customer's requirement or need. In the example, the taxpayer was uncertain about the successful execution of the horizontal drilling and the economic results from the targeted interval. To resolve that uncertainty, the taxpayer drilled several horizontal wells and modified its drilling program based on those results. If the taxpayer was merely adapting an existing business component to a particular customer's needs, then there would have been no need to drill multiple wells and modify the program based on those results. After the taxpayer had taken all these steps, the taxpayer's horizontal drilling program was at least ***improved***. As a result, the taxpayer's activities did not constitute adapting an ***existing*** business component to a particular customer's needs.

XII. The receipt of a purchase order does not mean that commercial production has begun: Rule 3.340(d)(1)(E)(iii) & 3.599(d)(1)(E)(iii).[89]

"Any research conducted after the beginning of commercial production of the business component" does not constitute "qualified research."[90] "Activities are conducted after the beginning of commercial production of a business component if such activities are conducted after the component is developed to the point where it is ready for commercial sale or use, or meets the basic functional and economic requirements of the taxpayer for the component's sale or use."[91]

The Amended Rules include an example that involves the manufacturing of integrated circuits. In the example, "the taxpayer and the potential customer enter an agreement for the delivery of an order of the integrated circuits."[92] The example concludes that "[a]ny research that occurs after an agreement is reached are excluded as activities conducted after the beginning of commercial production."

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[89] Responding to Section IV.J.
[90] I.R.C. § 41(d)(4)(A).
[91] Treas. Reg. § 1.41-4(c)(2)(i).
[92] 34. TEX. ADMIN. CODE §§ 3.340(d)(1)(E)(iii) & 3.599(d)(1)(E)(iii).

The example inappropriately sets a line for when commercial production begins as the date "the taxpayer and potential customer enter an agreement for the delivery of an order of the integrated circuits." Entering into an agreement for the delivery of an order does not mean that a product "is ready for commercial sale or use" or "meets the basic functional and economic requirements of the taxpayer for the component's sale or use."

XIII. The Amended Rules are unconstitutionally retroactive: Rules 3.340(i)(1) & 3.599(a)(1).[93]

The Comptroller first published the amendments to Rules 3.340 and 3.599 in the Texas Register on April 15, 2021. With minor revisions, the Comptroller published the final amendments in the Texas Register on October 15, 2021. The amendments were effective October 24, 2021.

Rule 3.599(a)(1) provides that the "provisions of this section apply to franchise tax reports originally due on or after January 1, 2014." Likewise, Rule 3.340(i)(1) provides that "[t]he provisions of this section apply to the sale storage, or use of tangible personal property occurring on or after January 1, 2014."

[93] Responding to Sections V. VI. & VII.

The Comptroller contends that the amendments to Rules 3.340 and 3.599 did nothing to change the law. The Comptroller also contends that if the amendments did change the law, then those amendments are not unconstitutionally retroactive.

The Comptroller did not provide any evidence, other than conclusory statements, to support his assertion that the Amended Rules are "expositions of existing Comptroller policy" or that the policy "has conformed to the statutes that created the tax breaks since the day the statutes went into effect."[94] The Comptroller's conclusory statements are not competent summary judgment evidence.[95]

Moreover, the Comptroller published further proposed amendments to Rules 3.340 and 3.599 in the Texas Register on June 10, 2022.[96] If the Amended Rules represent the Comptroller's existing interpretation and set forth a proper construction of the governing statutes, then further amendments would not be necessary.

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[94] Defendants' Motion for Summary Judgment, p. 27.
[95] *See LMB, Ltd. v. Moreno*, 201 S.W.3d 686, 689 (Tex. 2006); *Texas Division-Tranter, Inc. v. Carrozza*, 876 S.W.2d 312, 314 (Tex. 1994).
[96] Defendants' Motion for Summary Judgment, p. 7 n. 1, Exhibits 1-4.

The Comptroller argues that, if the Amended Rules represent changes in the law, then they are not unconstitutionally retroactive. In support, the Comptroller makes four assertions: (1) the research and development tax incentives are only available to certain taxpayers; (2) the Amended Rules set forth permissible interpretations of the governing statutes; (3) the applicability of the research and development tax incentives was not settled; and (4) the rules serve the public interest by providing guidance regarding what activities qualify for the research and development tax incentives.

None of these arguments set forth a "compelling justification" that is sufficient to overcome the "presumption that a retroactive law is unconstitutional."[97] If any of those arguments do constitute a compelling justification, then no retroactive rule would be unconstitutional. All taxing statutes apply to some taxpayers and not others. All rules must set forth an interpretation that is consistent with the governing statutes, choose between different permissible interpretations of those statutes, and provide guidance to taxpayers.

[97] *Robinson v. Crown Corp. & Seal Co., Inc.*, 335 S.W.3d 126, 145 (Tex. 2010).

The Texas Constitution's prohibition against retroactive laws "protects settled expectations that rules are to govern the play and not simply the score, and prevents the abuses of legislative power that arise when individuals or groups are singled out for special reward or punishment."[98] Taken at his word, the Comptroller adopted the amendments after "several years of experience administering the R&D exemption and credit."[99] The Amended Rules, therefore, represent the Comptroller's after the fact determination that some claims taxpayers have made are valid and others are not. These after-the-fact changes govern the score, not the play.

[98] *Id.*
[99] Defendants' Motion for Summary Judgment, p. 6.

Respectfully submitted,

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APPENDIX

20. TTARA/COST Comment

21. I.R.S Notice 2001-19, 2001-1 C.B. 784 (Feb. 1, 2001)

22. TXOGA Comment

23. Supplemental Affidavit of Michael Thompson

Certificate of Service

I hereby certify that a true and correct copy of the foregoing has been served on all counsel of record, as listed below, by electronic service on June 17, 2022.

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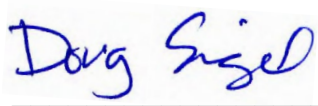

Doug Sigel

EXHIBIT
20

TEXAS TAXPAYERS
TTARA
AND RESEARCH ASSOCIATION

COST
COUNCIL ON STATE TAXATION

May 15, 2021

Ms. Teresa Bostick
Director, Tax Policy Division
Texas Comptroller of Public Accounts
P.O. Box 13528
Austin, Texas 78711-3528

Re: Proposed Franchise Tax Rule 34 TAC §3.599 and Sales Tax Rule 34 TAC §3.340, as published in the Texas Register on April 16

Dear Director Bostick:

The Texas Taxpayers and Research Association (TTARA) and the Council On State Taxation (COST) jointly offer our comments on the above-referenced rules relating to research and development (R&D). These amended rules will apply to the sales tax exemption (Texas Tax Code 151.3182) and the franchise tax credit (Texas Tax Code 171, Subchapter M) created in HB 800, passed in 2013 and authored by State Representative Murphy, 4 joint-authors and 74 coauthors.

As you recall, TTARA was actively involved in supporting and assisting in the drafting of the legislation. Lawmakers were clear in their stated purposes of the act:

1. Make Texas economically competitive in the field of research and development;
2. Reduce the tax burden on research and development activities in Texas and encourage new investments in this state;
3. Promote the creation of new, highly skilled, high-paying jobs in Texas; and
4. Complement this state 's manufacturing industries by encouraging innovation and efficiency in applying new technologies and producing new products.

The bill has been a success. In 2013, Texas, home to 8.4 percent of the nation's population accounted for only 3.4 percent of the nation's spending on research and development.[1] In 2017, the last year for which data are available, Texas' share had grown to 4.9% — a substantial improvement, though still far below where Texas should be.

We have concerns that the agency's proposed rules will make Texas' incentive narrower and more restrictive that the legislature intended. Texas' R&D provisions will be less attractive than that available in 34 other states. That will harm Texas' ability to compete with other states for R&D investment and hamper the ability of the state to achieve the purposes of the original Act. We believe the state should

[1] National Science Foundation, Science and Engineering State Profiles, Total R&D Performance, selected years.

do nothing to blunt this development, and are concerned that the rules as proposed would severely constrain what the Texas Legislature intended as a generous invitation to businesses to invest in R&D activities in the state.

Our members have brought several questions and concerns we would like to bring to the agency's attention. Because the two proposed rules include very similar language, our comments apply to both rules, unless specifically stated otherwise.

1. **Federal Conformity.** The proposed rules adopt many of the provisions of the federal tax credit under IRC 41 and the associated regulations adopted by the Treasury Department; but then what we would normally consider a positive step turns negative as the state imposes a separate set of standards—all more restrictive—applying them independently of a determination made by the IRS. The rules require taxpayers deemed eligible for the federal credit to prove, with the application of a separate set of standards, that those same expenditures are eligible for the Texas credit/exemption. In each of the cases noted below, the state's deviation from the federal administration of the credit raises the bar for qualifying for the credit in Texas. This is particularly troubling from a policy perspective, as Texas's credit will be diminished not just relative to federal law, but also relative to the research and development incentives available in other states.

   a. 2011 Reference Year. Texas Tax Code §171.651(1) and 151.3182(a)(2) connect the Texas credit to the Internal Revenue Code as it existed on December 31, 2011; however, the proposed rules contravene that by ignoring subsequent federal regulations applying to that federal statutory language if the regulation did not specifically "require" it be applied to the 2011 tax year.[2] The proposed rule would specifically exclude certain federal regulations that a taxpayer was permitted to apply to their 2011 return.[3]

   Tax Code §171.651(1) specifically states that the definition of IRC includes "any regulations adopted under that code *applicable* [emphasis added] to the tax year to which the provisions of the code in effect on that date applied." A federal regulation that gives the taxpayer the option of applying it to their 2011 tax year is indeed applicable to 2011, whether the taxpayer opted to apply it or not. The Comptroller's proposed rule creates a more restrictive standard in conflict with the one in the Tax Code.

   Regardless, other post-2011 regulations apply to the language in the IRC as it existed in 2011, though not retroactively to the 2011 tax return. These federal regulations provide greater clarity for taxpayers, but under the Comptroller's proposed rule Texas disregards them and instead defers to confusion. Taxpayers will have to maintain multiple sets of books based on the same language in law, but with differing regulatory interpretations.

   b. Internal Use Software. The proposed franchise tax rule, 34 TAC §3.599(d)(5) simply denies the franchise tax credit for "Any research activities with respect to internal use software." This

[2] Proposed 34 TAC §3.599((a)(5) adds a new sentence: "A regulation adopted after December 31, 2011 is only included in this term ["Internal Revenue Code"] to the extent that the regulation *requires* [emphasis added] a taxable entity to apply the regulation to the 2011 federal income tax year.

[3] An example of this is Treasury Regulation §1.41-4, adopted October 3, 2016.

conflicts with the 2011 federal code that directly specified that internal use software qualifies provided it meets certain conditions, specifically:

1. The software satisfies the requirements of Section 41(d)(1),
2. The research is not excluded under Section 41(d)(4), and
3. The software satisfies the high threshold of innovation test.[4]

Further, the Treasury Department has since adopted regulations providing guidance by which internal use software can more broadly qualify for the federal credit. Though it was not in effect in 2011, we believe the rules should incorporate these provisions to provide greater conformity with the federal credit and minimize compliance burdens and financial uncertainty with the Texas credit.

c. Standard of Proof. The agency rules place the burden of proof on the taxpayer to establish its entitlement to the credit/exemption by clear and convincing evidence. This evidence standard is unnecessarily higher than the preponderance-of-the-evidence standard required by the IRS, and is not found in Texas statutes, but instead has been adopted by prior regulation of the agency[5]. The higher burden of proof will deter, rather than encourage, research and development investment in Texas. It creates uncertainty, where there is none in other states. Why gamble on a dollar in Texas when you're guaranteed the dollar elsewhere?

d. Supplies Used in Manufacturing. HB 800 was designed to allow taxpayers a choice between a franchise tax credit or a sales tax exemption on research and development expenses. Taxpayers may choose one or the other, but not both. Proposed 34 TAC §3.599 takes this a step beyond to the level of individual transactions. Proposed 34 TAC §3.599(a)(8)(A)(iii) provides that a taxable entity may not include an item as a qualified research expense if it claimed a sales and use tax exemption based on an exempt use. We find no such restriction in either IRC §41 or Tax Code Chapter 171 Subchapter M.

Tax Code Chapter 171.653 provides that a taxable entity may not claim the franchise tax credit if it claimed a sales and use tax exemption under Tax Code 151.3182. No other exemptions are referenced.

Treasury Regulation 1.174-2(a)(1) states:

> *The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred <u>after production begins</u>* [emphasis added] *but before uncertainty concerning the development or improvement of the product is eliminated.*

Texas ties to the federal credit. The federal credit allows certain costs incurred after production (i.e., manufacturing) begins to be included as an eligible expense. Items purchased for use in manufacturing are exempt under Tax Code 151.318 or 151.3181. Tax Code 171.653 only identifies one sales tax exemption claimed that negates eligibility for the franchise tax credit – Tax Code

[4] T.D. 9786, effective October 4, 2016.
[5] 34 TAC §1.26(c).

151.3182. Therefore, a taxpayer claiming the franchise tax credit should be able to include certain production costs allowable under 1.174-2(a)(1) regardless of whether a sales tax exemption other than Tax Code 151.3182 is claimed.

e. Recordkeeping. Proposed 34 TAC §3.599(e)(2)(B) and 3.340(b)(6) require contemporaneous business records to support the research credit and the sales and use tax exemption, respectively.

The requirement for contemporaneous business records is often interpreted by agents as precluding other types of records or evidence, such as corroborating evidence or testimony, which are often just as relevant, if not more so, than the contemporaneous business records listed above. Furthermore, the nature of the certain industries may not lend itself to the creation or retention of the type of contemporaneous business records envisioned by the Comptroller. For instance, proposed 34 TAC §3.599(c)(1)(D)(vi)[6] lists four factors to be considered in determining whether a taxpayer is engaged in a trial-and-error methodology that is an experimental systematic trial and error (eligible for the research credit) or non-experimental simple trial and error (not eligible for the research credit); three of the four factors include specific documentation as follows:

- Whether all the results of the trial-and-error methodology are recorded for evaluation,
- Whether there is a written procedure for conducting the trial-and-error methodology, and
- Whether there is a written procedure for evaluating the results of the trial-and-error methodology.[7]

These types of records may not be kept by taxpayers in specific industries. It is challenges such as these that ultimately led the IRS to reject any specific documentation requirement for the research credit under IRC §41.

More specifically, the preamble to the final regulations of which the current Treas. Reg. §1.41-4(d) was a part, notes that the proposed regulations did not contain a specific recordkeeping requirement beyond the requirements set out in IRC §6001 and the corresponding regulations,[8] reflecting Congress' stated desire in 1999 when the federal credit was extended:

> *The conferees also are concerned about unnecessary and costly taxpayer record keeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable recordkeeping requirements.* [9]

As a result, the IRS stated in 2001:

> *Treasury and the IRS have re-evaluated whether a research credit-specific documentation requirement is warranted and have concluded that the high degree of variability in the objectives and conduct of research activities in the United States compels a conclusion that taxpayers must be provided reasonable flexibility in the manner in which they substantiate*

[6] See proposed 34 TAC §3.340(c)(1)(D)(vi)(II) – (IV) for similar provisions applicable to the SUT exemption.
[7] Proposed 34 TAC §3.599(c)(1)(D)(vi)(II) – (IV).
[8] 69 Fed. Reg. 22 at 24 (2004).
[9] *Id.*

> *their research credits. Accordingly, Treasury and the IRS have concluded that the failure to keep records in a particular manner (so long as such records are in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit) cannot serve as a basis for denying the credit. Treasury and the IRS have decided that the rules generally applicable under section 6001 provide sufficient detail about required documentary substantiation for purposes of the research credit. Consequently, no separate research credit-specific documentation requirement is included in these proposed regulations.*[10]

Thus, records kept in the ordinary course of the taxpayer's business which otherwise meet the general recordkeeping requirements of the Internal Revenue Code suffices for federal research credit purposes. For Texas to impose recordkeeping requirements more extensive than that of the IRS specifically deviates from the very federal law and regulations Texas has adopted by reference.

2. **Combined Reporting of Franchise Tax Credit (Tax Code Chapter 171)**. We believe that requiring each member of a combined group to calculate the research and development credit separately must be made by statute and not by the agency's rule.

   Tax Code §171.002(a) first defines a taxable entity to include a combined group. Tax Code §171.656 provides that "[a] credit under this subchapter for qualified research expenses incurred by a member of a combined group must be claimed on the combined report required by Tax Code §171.1014 for the group, and *the combined group is the taxable entity for purposes* of this subchapter [emphasis added]." However, proposed 34 TAC §3.599(i)(5) requires each member of the combined group to calculate the credit separately by changing the definition of taxable entity to mean a separate group member. This change is inconsistent with the statute.

   Furthermore, proposed 34 TAC §3.599(i)(4) changes the research and development credit calculation by requiring that the higher education rate applied for contracting with a higher education institution for qualified research be applied separately to each entity within the combined group and not to the combined group as a whole. This change is only possible by changing the definition of a taxable entity to mean an individual member of the consolidated group. Thus, we believe that changes in proposed 34 TAC §3.599(i)(4) and (5) should be excluded and addressed by statute.

   Further, this particular change in policy directly reduces the amount of the credit taxpayers have claimed. It will indeed have a very direct fiscal impact on taxpayers by reducing the amount of the credit, though the agency preamble to proposed 34 TAC §3.599 states:

   > *The proposed amendment would have no significant fiscal impact on the state government, units of local government, or individuals. There would be no significant anticipated economic costs to the public.*

[10] 66 F.R. 66362, 66366 (December 26, 2001) (Emphasis added). The proposed regulations were finalized on January 2, 2004, T.D. 9104, 69 F.R. 22 (January 2, 2004), with no changes made to the elimination of the recordkeeping requirement.

3. **Design**. Proposed 34 TAC §3.599(c)(1)(C)(ii) and 3.340(c)(1)(C)(ii) would create the following limitation with respect to the Business Component Test (an element of the Four-Part Test required for satisfying the definition of Qualified Research):

> *(ii) A design is not a business component because a design is not a product, process, computer software, technique, formula, or invention. While uncertainty as to the appropriate design of a business component is a qualifying uncertainty for the Section 174 Test and the Discovering Technological information test, the design itself is not a business component. For example, the design of a structure is not a business component, although the structure itself may be a business component. Similarly, a blueprint or other plan used to construct a structure that embodies a design is not a business component.*

As an initial matter, a design can certainly be a product, requiring significant research and experimentation. For instance, engineers often develop innovative design concepts and solutions which are embodied in design documents that comprise the design deliverables contracted for by clients. Such design deliverables comport with the common definition of a product which is "something produced," "something (such as a service) that is marketed or sold as a commodity."[11] Further, not all designs—whether created by a taxpayer for use in its business or contracted for by another—translate into physical structures, yet if qualified research was undertaken to develop them, a taxpayer should not be any less eligible to claim a research credit or the SUT exemption simply because the object of the design was either ultimately not constructed or was for something not tangible. Such a result would be wholly inconsistent with the purpose of the research credit/SUT exemption.

Moreover, there is no exclusion of design from the definition of a business component under IRC §41 or the regulations thereunder. As such, the proposed amendment is inconsistent with the plain meaning of the Texas Tax Code which provides that both "qualified research" and "qualified research expenses" have the meaning assigned by IRC §41.[12] For these reasons, design should not be excluded from eligibility as a business component.

4. **Examples.** We appreciate the Comptroller providing a number of examples in both rules of how a taxpayer may or may not qualify for the credit/exemption; however, the examples of a denial of eligibility are twice the number of examples with an affirmative result. Additional examples of an affirmative result would be beneficial in providing greater clarity.

In particular, the rules offer examples of activities performed by oil and gas operators that are not included in the federal regulations applicable to the research and development credit and that do not qualify [proposed 34 TAC §3.599(c)(1)(D)(VII) and (VIII), herein referred to as Example 7 and Example 8]. The proposed rules explain that each of these examples fails the Four-Part Test because the activities do not constitute a process of experimentation.

The hypothetical facts provided in Example 7 ignore the many other technical uncertainties that must be overcome in order to design a successful drilling operation. Selecting technology, even

[11] https://www.merriam-webster.com/dictionary/product
[12] Tex. Tax Code §171.651(4) and 151.3182(a)(3).

from commercially available options, is only one aspect of the development process required to achieve a successful system design. As the Comptroller correctly acknowledges in the proposed rules, a taxpayer "may undertake a process of experimentation if there is no uncertainty concerning the taxable entity's capability or method of achieving the desired result so long as the appropriate design of the desired result is uncertain as of the beginning of the taxable entity's research activities."[13] Moreover, consistent with the federal regulations, the Comptroller also acknowledges that taxpayers may "employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science."[14] Accordingly, we believe the agency should reconsider Example 7.

Example 8 is similarly misleading as it also fails to acknowledge the complexities of designing a successful drilling operation and further, that technical uncertainties can—and often do—exist, even when certain elements of the system design are known. Moreover, to the extent Example 8 stands for the proposition that the Process of Experimentation Test can be met only if more than one alternative is evaluated, it is clearly erroneous. Under both the federal regulations and the Comptroller's proposed regulations, the Process of Experimentation Test may be met even if only one alternative is evaluated. Specifically, Treasury Regulation §1.41-4(a)(5)(i) provides as follows:

> *[A] process of experimentation is a process designed to evaluate **one or more** alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. [*emphasis added*].*

The Comptroller's proposed regulations are in line with the federal regulations in that it requires only that the process of experimentation *generally* be *capable* of evaluating more than one alternative; there is no requirement that more than one alternative, in fact, be evaluated. The language in the Comptroller's proposed regulations is as follows:

> *(ii) A process of experimentation must:*
>
> *(I) be an evaluative process and generally should be capable of evaluating more than one alternative....*[15]

For these reasons, the agency should also reconsider Example 8.

We have similar concerns with a third example. Similar to Treas. Reg. §1.41 -4(c)(3), proposed 34 TAC §3.599(d)(2) provides that an activity will not be excluded merely because the business component is intended for a specific customer. The application of this rule is illustrated in a series of examples, including an example of activities performed by an oil and gas operator in proposed 34 TAC §3.599(d)(2)(F). In this example, the oil and gas operator's drilling activities are "excluded from the definition of qualified research because the activities consisted of adapting an existing business component (its existing horizontal drilling process) to meet a particular customer's need." As written, we believe the oil and gas operator's activities are denied merely because they were

[13] Proposed 34 TAC §3.599(c)(1)(D)(iii); and proposed 34 TAC §3.340(c)(1)(D)(iii).
[14] Proposed 34 TAC §3.599(c)(1)(B)(ii); and proposed 34 TAC §3.340(c)(1)(B)(ii).
[15] Proposed 34 TAC §3.599(c)(1)(D)(ii)(I); and proposed 34 TAC §3.340(c)(1)(D)(ii)(I).

performed for a specific customer. Even if economic results are considered, improving a process for improved performance or reliability is a qualified purpose under the process of experimentation test. In the interest of clarity, we would ask the agency to update the example to clearly illustrate why the oil and gas operator's activities should be excluded and that another example be added illustrating an oil and gas operation that qualifies for the credit even though it was intended for a specific customer.

In the interest of clarity, we would request that the Comptroller add examples illustrating an oil and gas operation that it would determine does meet the Four-Part Test in situations where the activities are not considered commercially available options, as well as where the taxable entity's activities are evaluating alternative methods.

Finally, many of the examples appear to be derived from IRS Audit Guidelines from the early 2000s. A major concern for today's business environment is that the technological references in the guide—and in the rules—do not address today's technology, like cellular phone technology, blockchain, web-based services or cloud computing that often are a central focus of today's R&D activities for many firms. It would provide greater clarity if affirmative examples could be included for more advanced technologies.

5. **Retroactivity**. Prior to these proposed rules, many taxpayers claiming a Texas R&D credit or the sales and use tax exemption did so on the belief that the federal regulations applicable to the research credit under IRC §41 applied with equal force to the Texas incentives. The proposed rules contain numerous substantive provisions we have noted above, that not only diverge from that of IRC §41 and the federal regulations, they consistently act to raise the bar of eligibility for the Texas credit/exemption. Accordingly, applying these rules retroactively by seven years to 2014 is fundamentally unfair. Further, it may do immediate and direct harm to companies that may have to amend previously-filed financial statements, and should be avoided.

We appreciate the opportunity to offer these comments on behalf of TTARA and our members, and are always available at your convenience to discuss further.

Sincerely,

Dale Craymer
Texas Taxpayers and Research Association

Patrick Reynolds
Council On State Taxation

EXHIBIT 21

Notice 2001-19 (IRS NOT), 2001-10 I.R.B. 784, 2001-1 C.B. 784, 2001 WL 84197

Internal Revenue Service (I.R.S.)

IRS NOT
Notice

COMMENTS ON RESEARCH CREDIT REGULATIONS

Released: February 1, 2001
Published: March 5, 2001

***1 Comments on research credit regulations.** This notice announces that the Treasury Department and the IRS will review the research credit final regulations in T.D. 8930 (2001-5 I.R.B. 433), and that comments are requested on the final regulations. Upon completion of this review, Treasury and the IRS will announce changes to the regulations, if any, in the form of proposed regulations. In addition, T.D. 8930 will be revised so that the provisions of the regulations, including any changes, will be effective no earlier than the date the review is completed. However, the provisions related to internal-use computer software (including any revisions) generally will be applicable to taxable years beginning after December 31, 1985. Comments should be submitted by April 2, 2001.

On January 3, 2001, the Treasury Department published final regulations (T.D. 8930, 2001-5 I.R.B. 433) relating to the computation of the research credit under § 41(c) and the definition of qualified research under § 41(d) in the Federal Register (66 F.R. 280). These regulations reflect changes to § 41 made by the Tax Reform Act of 1986, the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998, and the Tax Relief Extension Act of 1999.

The Treasury Department and the Internal Revenue Service will review these final regulations. Comments are requested on all aspects of the final regulations with specific comments requested on whether modifications should be made to the documentation requirement contained in § 1.41-4(d). As part of this review, the Treasury Department and the Service will reconsider all comments previously submitted in connection with the finalization of T.D. 8930. Comments should be submitted by April 2, 2001, and sent to: CC:M&SP:RU (T.D. 8930), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:M&SP:RU (T.D. 8930), room 5226, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20044. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page or by submitting comments directly to the IRS

Internet site at *http:// www.irs.ustreas.gov/tax_ regs/regslist.html.* All submissions will be open to public inspection.

Upon the completion of this review, the Treasury Department and the Service will announce changes to the regulations, if any, in the form of proposed regulations. In addition, T.D. 8930 will be revised so that the provisions of the regulations, including any changes to T.D. 8930, will be effective no earlier than the date when the completion of this review is announced, except that the provisions related to internal-use computer software (including any revisions) generally will be applicable for taxable years beginning after December 31, 1985.

Taxpayers may continue to rely on T.D. 8930 during the pendency of this review.

For further information regarding this notice, contact Lisa Shuman of the Office of the Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622-3120 (not a toll-free call).

Notice 2001-19 (IRS NOT), 2001-10 I.R.B. 784, 2001-1 C.B. 784, 2001 WL 84197

End of Document

EXHIBIT
22

TXOGA
TEXAS OIL & GAS ASSOCIATION | SINCE 1919

Alan L. Smith
Chairman

D. Todd Staples
President

May 14, 2021

Teresa G. Bostick, Director
Tax Policy Division
Texas Comptroller
P.O. Box 13528
Austin, TX 78711-3528

Dear Ms. Bostick:

Thank you for allowing Texas Oil and Gas Association (TXOGA) to comment on proposed changes to rules 3.340 and 3.599 pertaining to research and development. TXOGA is a non-profit corporation representing every sector of the oil and natural gas industry in the state of Texas. The membership of TXOGA produces in excess of 90 percent of Texas' crude oil and natural gas, operates over 80 percent of the state's refining capacity, and is responsible for the vast majority of the state's pipelines. In fiscal year 2020, the oil and natural gas industry provided more than 400,000 direct jobs and paid $13.9 billion in state and local taxes and state royalties, funding our municipalities, public schools and universities, roads and first responders.

The comments below focus on the research and development credit in 3.599 but also pertain to 3.340 where applicable.

Time Periods

As drafted, the proposed changes would apply retroactively to franchise tax reports originally due on or after January 1, 2014. Retroactive application of rule changes that are detrimental to taxpayers would be a very troubling practice. We request that if these rules are adopted, they apply prospectively to tax reports due after May 2021.

A separate, state interpretation of Treasury regulations §§ 1.41-4(c)(6) and 1.174-2(a) would put a significant burden of having separate research and development activities for federal and state purposes, hurting Texas' competitiveness for R&D expenditures. The proposed rule would limit the applicability of the Treasury regulations to those that are mandatorily retroactive, excluding any federal regulation that may, at the taxpayer's option, be applied retroactively. This Texas statute provides no such limitation.

Four-Part Test

TXOGA agrees that defining the term "Four-Part Test" as derived from IRC § 41 and the applicable regulations thereunder improves the readability of the rules. However, relying on the federal definition of the Four-Part Test but applying a different standard of proof than the federal rules is unreasonable and burdensome to taxpayers. In following the federal rules for establishing the Four-Part Test, we recommend that the agency apply the standard of proof applicable under the federal rules. The "clear and convincing evidence" standard is unnecessarily high, given that the purpose of the incentive is to encourage R&D activity. Also, requiring that research expenses be supported by contemporaneous business records is

Exhibit A

unnecessarily burdensome. Combined with the fact that the oil and gas industry does not lend itself to the creation of the type of contemporaneous records that the agency may require, it is questionable whether the industry could ever prove qualification.

Additionally, the proposal includes examples of activities performed by oil and gas operators that the agency believes are not eligible, explaining that the activities do not constitute a process of experimentation. Examples 7 and 8 are incomplete as they do not take into account the complexities of designing a successful drilling operation and further, that technical uncertainties can—and often do—exist, even when certain elements of the system design are known. In the interest of clarity, we request that the rule include examples illustrating oil and gas operations that do meet the Four-Part Test in situations where the activities are not considered commercially available options, as well as where the taxable entity's activities are evaluating alternative methods.

Similar to Treasury regulation § 1.41 -4(c)(3), proposed 3.599(d)(2) provides that an activity will not be excluded merely because the business component is intended for a specific customer. The application of this rule is illustrated in a series of examples, including an example of activities performed by an oil and gas operator in proposed 3.599(d)(2)(F). In this example, the oil and gas operator's drilling activities are "excluded from the definition of qualified research because the activities consisted of adapting an existing business component (its existing horizontal drilling process) to meet a particular customer's need." As drafted, it appears that the oil and gas operator's activities are denied merely because they were performed for a specific customer. Even if economic results are considered, improving a process for improved performance or reliability is a qualified purpose under the process of experimentation test. We would ask that the current example be updated to clearly illustrate why the operator's activities should be excluded, and that another example be added illustrating an oil and gas operation that qualifies for the credit even though it was intended for a specific customer.

Proposed (c)(1)(C)(ii) in both rules would create a limitation with respect to the Business Component Test by providing that design is not a business component. Design can require significant research and experimentation. Engineers often develop innovative design concepts and solutions which are embodied in design documents. While not all designs are translated into physical structures, a taxpayer's activities should be eligible if the object of the design was either ultimately not constructed as that would be consistent with the purpose of the incentive.

Combined Reporting

We believe that a change requiring each member of a combined group to calculate the research and development credit separately would be appropriately addressed in statute rather than by rule.
Tax Code 171.002(a) first defines a taxable entity to include a combined group. Section 171.656 provides that "[a] credit under this subchapter for qualified research expenses incurred by a member of a combined group must be claimed on the combined report required by Section 171.1014 for the group, and *the combined group is the taxable entity for purposes* of this subchapter [Subchapter M Tax Credit for Certain Research and Development Activities.]" (emphasis added). However, proposed 3.599(i)(5) requires each member of the combined group to calculate the credit separately by changing the definition of taxable entity to mean a separate group member. This change is inconsistent with the statute.
Furthermore, proposed 3.599(i)(4) changes the research and development credit calculation by requiring that the higher education rate applied for contracting with a higher education institution for qualified

research be applied separately to each entity within the combined group and not to the combined group as a whole. This change is only possible by changing the definition of a taxable entity to mean an individual member of the consolidated group. Thus, we believe that changes in proposed 3.599(i)(4) and (5) should be excluded and if appropriate, addressed by statute.

Again, thank you for considering industry input into this rule-making. If you need any additional information, please let us know.

Sincerely,

Shannon Rusing
Vice President of Operations

EXHIBIT
23

CAUSE NO. D-1-GN-21-006290

RYAN, LLC,	§	IN THE DISTRICT COURT
	§	
Plaintiff,	§	
	§	
v.	§	
	§	
GLENN HEGAR, IN HIS OFFICIAL CAPACITY AS COMPTROLLER OF PUBLIC ACCOUNTS OF THE STATE OF TEXAS AND THE OFFICE OF THE COMPTROLLER OF PUBLIC ACCOUNTS FOR THE STATE OF TEXAS,	§	353RD JUDICIAL DISTRICT
	§	
Defendant.	§	TRAVIS COUNTY, TEXAS

Supplemental Affidavit of Michael Thompson

BEFORE ME, the undersigned Notary Public, on this day personally appeared Michael A. Thompson who, being duly sworn on oath, deposed and stated as follows:

1. My name is Michael A. Thompson. I am over the age of 21, and I am fully competent to make this Affidavit. The facts stated herein are true and are based on observations I personally made during my employment with Ryan, LLC.

2. The statements in this Affidavit regarding my understanding of legal authorities (such as the Texas Tax Code, Comptroller Rules, Internal Revenue Code, and Treasury Regulations) are not intended to be legal opinions. Rather, those statements are included in this Affidavit to give context to the factual statements that follow.

3. I previously submitted an affidavit with Ryan, LLC's Motion for Summary Judgment.

4. This affidavit is intended to supplement the statements therein.

5. Texas Administrative Rules 3.340(c)(1)(D)(vii)(Examples VII and VIII) and 3.599(c)(1)(D)(vii)(Examples VII and VIII) are exact duplicates.

6. These examples conclude that if an oil and gas operator uses "technology from existing commercially available options to use in its horizontal drilling program" or its own "existing technology to perform its horizontal operations" then it has not engaged in a "Process of Experimentation Test."

7. In 15 plus years assisting oil and gas companies identify and substantiate research and development related tax incentives I have had

occasion to observe, review and analyze the drilling and completion of hundreds of oil and gas wells.

8. Examples 7 and 8 grossly oversimplify the technical process required to complete projects of this type and misconstrue how existing technologies are used in this industry.

9. A process for extracting oil and gas from a known reservoir almost always employs the use of commercially available components and portions of a taxpayer's existing technical knowledge.

10. In a sales tax exemption claim currently under examination by the Texas Comptroller, the taxpayer set about to more efficiently and reliably reach the desired true vertical depths and measured depths of several wells within the high-stress, heterogeneous lithologies present within the Wolfcamp B "Wolfbone" formation of Delaware Basin section of the Greater Permian Basin.

11. The processes and techniques developed were completely new to the taxpayer but relied heavily on a drilling process which utilized configurations of an existing drill bit, bottom hole assembly, mud pump, and other equipment.

12. In fact, none of the equipment included in these well plan configurations was new to the world or created by the taxpayer.

13. Under Texas Administrative Rules 3.340(c)(1)(D)(vii)(Examples VII and VIII) and 3.599(c)(1)(D)(vii)(Examples VII and VIII) the use of these existing technologies would automatically exclude these projects from qualifying for incentive treatment.

14. This would be the outcome despite the fact this taxpayer had no idea how to best configure, operate or deploy these components in the engineering design initially hypothesized.

15. In this exact example, the taxpayer's initial well design implemented the use of pilot holes which were drilled deeper than the intended landing spot of the horizontal well to help log and identify the scope of the play and anticipate existent subsurface issues.

16. The readings from the pilot holes for this well led the taxpayer to hypothesize that it could revise previous well design plans to incorporate depths for setting intermediate casing strings much shallower than ever done before.

17. This redesigned process for setting these intermediate casing strings, if successful, would have improved the functionality of the drilling process by requiring less vertical open hole time and exposing the open hole to higher pressures farther below ground therefore resulting in financial and time efficiencies.

18. This hypothesis was tested both via geological analysis and ultimately through observation and on-site experimentation during the drilling operation.

19. The initial plan called for drilling and running 13 3/8 inch surface casing strings to a depth of approximately 1,550 feet.

20. From this point, intermediate strings with a diameter of 9 5/8 inches would then be run to a depth of 9,650 feet where 5 to 5 ½ inch production casing would be introduced and run the expanse to the final depth of 16,000 feet.

21. As early as Day 3 of the drilling on this well, and at only 1,374 feet, the taxpayer began experiencing stuck pipe issues forcing it to consider alternative redesigns of mud property methods and utilizing washing and reaming procedures.

22. To address each of the various Differential Pressure Sticking and Mechanical Pipe Sticking problems faced during the course of this project, the taxpayer analyzed several alternative techniques for freeing the stuck pipe.

23. Specifically, it looked at incorporating grooved drill collars, external-upset tool joints, reducing the hydrostatic pressure in the annulus by diluting mud weight, reducing mud weight through gasifying, and placing a packer in the hole above the stuck point; rotating and reciprocating the drillstring and increasing flow rate within equivalent circulating density parameters, or circulating fresh water in salt scenarios.

24. In Days 2 and 3 of the intermediate drilling operations, the taxpayer began experiencing downhole pressure loss and lost returns which required both further redesigning the mud properties utilized and introducing lost circulation materials not anticipated by initial designs.

25. These adjustments to the procedures resulted in washout of the open hole section and required the introduction of a new fresh water gel system to displace the hole.

26. To stem the tide of these problems, the taxpayer elected to redesign the components of the bottom hole assembly on Day 5 of intermediate drilling as it continued to experience tight hole conditions from the formation.

27. During intermediate drilling Days 10 through 12 the taxpayer had to deviate from its initial well design by completely introducing a new casing running tool to run its 9 5/8 inch casing and using DV Tools to run a multi-stage cement operation at 9,573 feet.

28. At this point, the taxpayer began drilling the curve and on Day 17 landed in a Wolfcamp B zone of unconsolidated "running" sands that were highly sensitive to the mud weights as initially designed and resulted in significant losses in circulation.

29. These unconsolidated, tennis ball sized chunks of shale and presence of gravel made wellbore stability a significant problem through the entirety of the production casing process and would ultimately result in the taxpayer having to completely scrap its initial well design and run a sidetrack in a completely different zone to achieve a producing well.

30. Specifically, the taxpayer would spend the next 20 days revising pre-planned mud weights, introducing 3 different bottom hole

assembly designs and continually washing and reaming the wellbore to maintain integrity.

31. At Day 22, the taxpayer had reached a measured depth on the well of 14,768. It was at this point the wellbore would lose complete stability and force the taxpayer to spend the next 7 days working stuck pipe in the zone between 9,570 and 9,850.

32. The taxpayer would never return to the previously achieved measured depth of 14,768 feet.

33. In fact, on Day 29, the open hole composition had deteriorated such that the taxpayer lost 264 feet of bottom hole assembly beginning at a depth of 9,588 feet and would spend the next 10 days traversing tight hole and experiencing stuck pipe issues trying to fish the lost bottom hole assembly from the wellbore to no avail.

34. It was here that the taxpayer analyzed several alternatives for continuing the drilling operation. It could, of course, abandon the well completely; continue drilling horizontally as originally planned and resume fishing attempts; setting a cement plug and attempting to sidetrack in the same Wolfcamp B formation around the fish; anchor a whipstock to the open hole to attempt sidetracking from there; or back

out of the hole to a shallower depth than originally designed, setting the whipstock against the intermediate casing and drilling a sidetrack in a higher zone.

35. The taxpayer elected to revise its drilling plan to set a Cast Iron Bridge Plug at 9,450 feet, back up the hole, set a whipstock at 8,990 feet and drill a sidetrack.

36. This redesign would only be successful if the taxpayer could somehow redesign the drilling procedures to incorporate a 7 5/8 inch liner at a speed that would prevent similar borehole collapse.

37. The new design called for the top of the liner to be anchored at 8,777 feet and run to a bottom depth of 10,250.

38. On Day 42, the whipstock was set and the redesigned sidetrack was commenced into the Wolfcamp A formation.

39. At 9,864 feet the kick-off point was achieved and the second curve was drilled to a landing point measured depth of 11,008 feet and a true vertical depth of 10,529 feet.

40. Production casing was run from the liner through a 6 ¾ inch production hole to a final measured depth of 15,953 feet relatively smoothly post redesign of the drilling process.

41. Every single piece of equipment utilized in the development and ultimate field testing of this hypothesized drilling process was commercially available and the plan incorporated techniques and processes the taxpayer had utilized previously.

FURTHER AFFIANT SAYETH NOT

MICHAEL A. THOMPSON
Director, R&E Tax Credits
Ryan, LLC

SUBSCRIBED AND SWORN TO BEFORE ME on this the 17th day of June, 2022.

Notary Public, State of Texas

My commission expires:
08/02/2025

AIDAN WALTON
Notary Public, State of Texas
Comm. Expires 08-02-2025
Notary ID 133245549